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**AUDIT RISK
ALERTS**

Audit Risk Alert—1991

**General Update on Economic, Industry,
Regulatory, and Accounting and
Auditing Matters**

**Issued by the
Auditing Standards Division**

AICPA

American Institute of Certified Public Accountants

NOTICE TO READERS

This audit risk alert is intended to provide auditors with an overview of recent economic, industry, regulatory, and professional developments that may affect the audits they perform. This document has been prepared by the AICPA staff. It has not been approved, disapproved, or otherwise acted upon by a senior technical committee of the AICPA.

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Audit Risk Alert—1991*

Introduction

This alert is intended to help auditors in planning their 1991 year-end audits. Successful audits are a result of a number of factors, including acceptance of clients with integrity; adequate partner involvement in planning, supervising, and performing audits; an appropriate level of professional skepticism; and the allocation of sufficient audit resources to high-risk areas. Addressing these factors in each audit engagement requires substantial professional judgment based, in part, on a knowledge of professional standards and current developments in business and government.

This alert identifies areas that, based on current information and trends, may be relevant to many 1991 year-end audits. Although it does not provide a complete list of risk factors to be considered and the items discussed do not affect risk in every audit, this alert can be used as a planning tool for considering matters that may be especially significant for 1991 audits.

Economic Developments

Implications of the Economic Downturn

The economic distress of 1990 has continued in 1991, and has been evidenced by an increase in corporate and personal bankruptcies and deteriorating operating results for many other businesses. However, by summer, some experts were stating that the recession had ended, but these experts also were predicting that the economic recovery would be modest and slow. Auditors should be aware of what effects the recession and the slowness of recovery may have had on their clients. Although the impact has been more significant in certain regions and in certain industries, few businesses can be immune when their suppliers, customers, and others in the business community have been affected.

The following reminders are equally applicable during periods of economic prosperity; however, their effects may be more significant or pervasive in the current economic climate:

*This Audit Risk Alert was published in the November 1991 issue of the AICPA's *CPA Letter*.

-
- Asset valuations should be challenged in considering whether amounts are recoverable and the bases of accounting are appropriate. The entity's policies and procedures for identifying impaired assets should be adequate in light of current conditions.
 - Inappropriate offsetting of assets and liabilities should be carefully evaluated.
 - Balances and transactions involving complex valuation judgments (for example, real estate held for investment or sale, or securities for which there is no ready market) and specialized inventories (for example, high-technology components and pharmaceutical products) should be carefully considered. In some situations, auditors should consider using a specialist to review valuations or, possibly, qualitative aspects of inventories, such as obsolescence or damage.
 - Changes in cost-deferral policies and the reasonableness of amortization periods should be carefully evaluated.
 - Allowances for doubtful accounts, in general, and loan-loss allowances for financial institutions, in particular, should be evaluated carefully and thoroughly.
 - Compliance with financial covenants and the necessity to obtain waivers from lending institutions to meet current requirements should be carefully reviewed.
 - Changes in sales practices or terms that may require a change in accounting should be identified and considered.
 - The possible effects of trends affecting a client's industry, such as recurring losses and asset writedowns, and the reasons for any changes in accounting practices, should be carefully evaluated.

Going-Concern Problems

The number of U.S. business failures jumped 20 percent in 1990, and the trend continued into 1991. The liabilities associated with failed businesses were large due to a number of heavily leveraged businesses that failed after they were unable to service their debt in a sluggish economy.

Financial statements are prepared on the assumption that an entity is a going concern. Statement on Auditing Standards (SAS) No. 59, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern* (AICPA, *Professional Standards*, vol. 1, AU sec. 341), requires auditors to evaluate *as part of every audit* whether there is substantial doubt about

the ability of an entity to continue as a going concern for a reasonable period of time, not to exceed one year beyond the date of the financial statements. Although SAS No. 59 does not mandate specific documentation requirements, SAS No. 41, *Working Papers* (AU sec. 339), requires documentation of *conclusions reached* in all audit engagements.

The following conditions may indicate a potential problem or could jeopardize the continued existence of an entity:

- Recurring operating losses
- Working capital deficiencies
- Default on loan or similar agreements
- Need to seek new sources or methods of financing, or to dispose of substantial assets
- External matters that have occurred (for example, the loss of a principal customer)

For auditors of public companies, guidance about going-concern matters is included in the Securities and Exchange Commission's (SEC's) Financial Reporting Release (FRR) No. 16, *Rescission of Interpretation Relating to Certification of Financial Statements*.

For auditors reporting on financial statements prepared on a liquidation basis of accounting, guidance is included in the auditing interpretation "Reporting on Financial Statements Prepared on a Liquidation Basis of Accounting" (AU sec. 9508.33). For entities that have filed petitions with the Bankruptcy Court and expect to reorganize under Chapter 11 of Title 11 of the Federal Bankruptcy Code, guidance can be found in the AICPA Statement of Position (SOP) 90-7, *Financial Reporting by Entities in Reorganization Under the Bankruptcy Code* (AICPA, *Technical Practice Aids*, vol. 2, sec. 10,460).

Unpaid Fees

Given current economic conditions, there may be an increase in the number of clients that have not paid all of their fees for prior services rendered by their CPA firms. Interpretation 52, "Unpaid Fees," under Rule 101, *Independence*, of the AICPA Code of Professional Conduct (AICPA, *Professional Standards*, vol. 2, ET sec. 191.103), states that independence is considered to be impaired if, when the current year's audit report is issued, fees remain unpaid, whether billed or unbilled, for *all* professional services performed more than one year prior to the current report date. For example, for a report dated March 31, 1992, all fees for professional services through March 31, 1991, must be paid before the issuance of the audit report for the current year.

Environmental Matters

The subject of environmental liabilities was discussed in *Audit Risk Alert—1990* (see the *CPA Letter*, December 1990) and continues to be of interest to investors, the SEC, and creditors.

The auditor should consider, through inquiries of management, whether the entity or any of its subsidiaries has been designated as a “potentially responsible party” (PRP) by the Environmental Protection Agency, or otherwise has a high-risk exposure to environmental liabilities. When more than one PRP is associated with a contaminated site, each party may be contingently liable for the full amount of cleanup costs and fines, due to the joint and several nature of environmental laws. Such exposure could result in the need for an entity to accrue for cleanup costs or disclose a contingency, and, possibly, necessitate the addition of an explanatory paragraph in the audit report.

Examples of “red flags” that may indicate an increased risk of an entity’s exposure to environmental liabilities include the following:

- Participation in a real estate transaction or corporate merger
- The purchase of land at a price significantly below local market prices (a possible “bargain” sale due to environmental risk)
- Aborted transactions that involved the client as a seller of real property
- Piecemeal sale of assets (while retaining real property)
- The acquisition of new or increased insurance coverage against environmental risks or liability to third parties

The AICPA frequently receives inquiries about how to account for environmental contingencies and liabilities and the related audit consequences. The applicable accounting literature includes Financial Accounting Standards Board (FASB) Statement No. 5, *Accounting for Contingencies* (FASB, *Current Text*, vol. 1, sec. C59), and Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss* (FASB, *Current Text*, vol. 1, sec. C59). In addition, guidance is included in the FASB’s Emerging Issues Task Force (EITF) Issue 89-13, *Accounting for the Cost of Asbestos Removal*, and Issue 90-8, *Capitalization of Costs to Treat Environmental Contamination*. In applying the accounting literature, auditors should be alert to the possibility of an inappropriate delay of the accrual of an environmental loss until sufficient information is available to determine the *best* estimate of the liability. Interpretation No. 14 requires entities to accrue a loss contingency when the estimated loss is within a range of amounts.

The applicable auditing guidance is found in SAS No. 12, *Inquiry of a Client’s Lawyer Concerning Litigation, Claims, and Assessments* (AU sec.

337); SAS No. 54, *Illegal Acts By Clients* (AU sec. 317); and SAS No. 57, *Auditing Accounting Estimates* (AU sec. 342).

For SEC registrants, disclosure is governed by *Regulation S-K*, Item 101, "Description of business"; Item 103, "Legal proceedings"; Item 303, "Management's discussion and analysis of financial condition and results of operations"; and FRR No. 36, *Management's Discussion and Analysis of Financial Condition and Results of Operations*.

New Auditing Pronouncements

New Standard Confirmation Form

When confirming cash and other information with financial institutions, auditors should use the new "Standard Form to Confirm Account Balance Information with Financial Institutions" and the accompanying illustrative letters (effective for confirmations mailed on or after March 31, 1991). The new form only provides for confirmation of deposit and loan balances. To confirm other transactions and arrangements, auditors should send a separate letter, signed by the client, to a financial institution official responsible for the financial institution's relationship with the client or knowledgeable about the transactions or arrangements. Copies of the new confirmation form (No. 057509) are available from the AICPA Order Department at (800) 334-6961 (outside New York) or at (800) 248-0445 (New York only).

New SAS on Internal Auditing

In April 1991, the Auditing Standards Board (ASB) issued SAS No. 65, *The Auditor's Consideration of the Internal Audit Function in an Audit of Financial Statements* (AU sec. 322), effective for audits of financial statements for periods ending after December 15, 1991. The SAS supersedes SAS No. 9, *The Effect of an Internal Audit Function on the Scope of the Independent Audit*, and incorporates the terminology and concepts of more recent SASs, particularly SAS No. 55, *Consideration of the Internal Control Structure in a Financial Statement Audit* (AU sec. 319).

The most important revision is the inclusion of guidance on assessing the *extent* to which the internal auditors' work can affect the scope of the audit, particularly in key audit areas. SAS No. 65 notes that as materiality, the risk of misstatement, and the subjectivity involved in evaluating the audit evidence increase, the greater the need for the *independent auditor* to perform the audit work. SAS No. 65 continues to allow the independent auditor considerable latitude in determining the effect of internal auditors' work on lower-risk audit areas. However,

the internal auditors' work should be tested by the auditor and, when the effect is more significant, the tests should be more extensive.

New SAS on Communications About Interim Financial Information

In June 1991, the ASB issued SAS No. 66, *Communication of Matters About Interim Financial Information Filed or to Be Filed With Specified Regulatory Agencies—An Amendment to SAS No. 36, Review of Interim Financial Information* (AU sec. 722). This SAS establishes requirements for an auditor to communicate to management, and, in certain situations, to audit committees, information about probable material misstatements affecting interim financial information filed or to be filed with the SEC, the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve System, or the Office of Thrift Supervision. SAS No. 66 is effective for interim financial information filed or to be filed for interim periods ending after September 15, 1991.

New SAS on Confirmations

In November 1991, the ASB issued SAS No. 67, *The Confirmation Process* (AU sec. 330), effective for audits of fiscal periods ending after June 15, 1992. This SAS provides practitioners with expanded guidance for using confirmations as audit evidence. Results from peer reviews have indicated that practitioners do not always design and evaluate confirmations properly.

Here are some considerations when using confirmations:

- *Prior Experience*—Reviewing results from prior years' audits or audits of similar types of entities, such as response rates and identified misstatements, can be helpful in designing the current year's requests. For example, prior years' results might indicate that respondents' accounting systems may facilitate the confirmation of transactions rather than account balances.
- *Nature of Information Being Confirmed*—Auditors should consider the substance of transactions being confirmed in determining the information to include on the confirmation request. In certain cases, auditors may want to confirm the terms of agreements or transactions in addition to the amounts. For example, if inherent and control risks over the occurrence of revenues related to an unusual, year-end sale of software are assessed as high, the auditor should consider using confirmation requests to confirm the terms of recorded transactions related to those revenues.

The auditor should also consider whether there may be oral modifications to agreements, such as unusual payment terms or

liberal rights of return. When the auditor believes there may be oral modifications, he or she should inquire about them and consider including those details in the confirmation request.

- *Respondent*—The respondent's objectivity and freedom from bias with respect to the audited entity can directly affect the quality of the confirmation. Especially for significant, unusual year-end transactions that have a material effect on the financial statements, the auditor should apply a greater degree of professional skepticism in evaluating the respondent.
- *Negative Confirmation Requests*—Negative confirmations may be used as a substantive procedure to reduce audit risk only when three conditions are met: (1) the combined assessed level of inherent and control risk is low, (2) a large number of small balances is involved, and (3) the auditor has no reason to believe that the recipients of the requests are unlikely to give them consideration.

Forthcoming Guidance on GAAP Hierarchy

The ASB plans to issue by January 1, 1992, a SAS that will revise the GAAP hierarchy in SAS No. 5, *The Meaning of "Present Fairly in Conformity With Generally Accepted Accounting Principles" in the Independent Auditor's Report* (AU sec. 411). Current plans would change the authority, in the GAAP hierarchy, of AICPA SOPs, Audit and Accounting Guides, and Practice Bulletins, as well as FASB EITF consensuses. Also, the proposed revisions would establish two parallel hierarchies: one for state and local governmental entities and one for nongovernmental entities.

The proposed revisions would require, for example, a nongovernmental entity that follows an industry accounting practice to change to an accounting treatment specified by AICPA SOPs that become effective after March 15, 1992. Also, since consensus positions of the EITF would have a greater authority than they do in the existing GAAP hierarchy, nongovernmental entities would be required to change their current accounting practices if they differed from EITF guidance issued after March 15, 1992. Practitioners should be alert to any changes in the final SAS, which will be effective for audits of financial statements for periods ending after March 15, 1992.

Exposure Draft on Service Organizations

On February 27, 1991, the ASB issued an exposure draft of a proposed SAS titled *Reports on the Processing of Transactions by Service Organizations*. The proposed SAS will supersede SAS No. 44, *Special-Purpose*

Reports on Internal Accounting Control at Service Organizations (AU sec. 324), which provides guidance to practitioners engaged to audit the financial statements of an entity that uses a service organization. SAS No. 44 is being revised to bring it into conformity with the requirements and conceptual framework established in SAS No. 55. An example of a service organization is a bank trust department that provides investment or administrative services to an employee benefit plan. If a user organization is affected by internal control structure policies and procedures at a service organization, the user auditor may find a service auditor's report helpful in gaining an understanding of an entity's internal control structure and in assessing control risk. The SAS is scheduled to be issued in the first quarter of 1992 and tentatively will be effective for audits of financial statements for periods ending after December 15, 1993, and for service auditors' reports dated after December 15, 1992.

Audit Communication and Reporting Issues

Communications Between Predecessor and Successor Auditors

SAS No. 7, *Communications Between Predecessor and Successor Auditors* (AU sec. 315), requires the successor auditor to attempt certain communications *before accepting an engagement*. Research shows that these inquiries sometimes are not made. SAS No. 7 requires inquiries to be made about facts relating to client integrity; disagreements with the client about accounting principles, auditing procedures, and other similar matters; and the predecessor's understanding of the reasons for the change of auditors. SAS No. 7 describes other communications that should be considered by the successor auditor and requires the predecessor auditor to respond promptly and fully to the successor's inquiries unless he or she indicates that the response is limited.

Reporting on Uncertainties

SAS No. 58, *Reports on Audited Financial Statements* (AU sec. 508), requires an auditor to add an explanatory paragraph (after the opinion paragraph) to the standard report when a material uncertainty is expected to be resolved at a future date. Examples of such uncertainties include lawsuits against the entity and tax claims by tax authorities when precedents are not clear. Because resolution is prospective, management sometimes cannot estimate the effect of an uncertainty on the entity's financial statements. However, in some cases, other situations in which management asserts that it is unable to estimate certain financial statement elements, accounts, or items have been inappropriately treated as uncertainties.

Generally, matters that relate to typical business operations and the outcomes of which depend on the actions of management should be susceptible to reasonable estimation and, therefore, are estimates inherent in the accounting process—not *uncertainties*. An assertion by management that it is not able to estimate in these situations should raise concerns about the possibility of financial statement misstatement or a scope limitation. If the auditor believes that financial statements are materially misstated, a qualified or adverse opinion is required due to the GAAP departure. A scope limitation should result in a qualified opinion or a disclaimer of opinion. An explanatory paragraph describing an uncertainty may be included in the audit report *only* after the auditor has determined that the financial statements are prepared in accordance with GAAP.

Communication With Audit Committees

SAS No. 61, *Communication With Audit Committees* (AU sec. 380), establishes a requirement for the auditor to determine that certain matters related to the conduct of an audit are communicated to those who have responsibility for oversight of the financial reporting process. The communications required by SAS No. 61 are applicable to entities that either have an audit committee or that have otherwise formally designated oversight of the financial reporting process to a group equivalent to an audit committee (such as a finance committee or a budget committee), and to all SEC engagements. The SAS requires the auditor to ensure that the audit committee receives additional information regarding the scope and results of the audit that may assist the audit committee in overseeing the financial reporting and disclosure process for which management is responsible. Auditors should make sure that this information is communicated to the audit committee in an understandable, nontechnical manner. The AICPA publishes a brochure for audit committee members, *Communication With Audit Committees (or Others With Similar Responsibilities)*, which describes the auditor's responsibilities to communicate certain audit and accounting matters to the audit committee. The brochure (No. 022029) is available from the AICPA Order Department at (800) 334-6961 (outside New York) or at (800) 248-0445 (New York only).

Audit Problems to Watch for

Audit Programs

In accordance with paragraph .05 of SAS No. 22, *Planning and Supervision* (AU sec. 311), *written* audit programs, adequately tailored to

reflect each client's situation, including areas of greater audit risk, are required in *all* audits. Audit programs are even required for audits involving sole practitioners when no staff is used on the engagement. The audit program is required to demonstrate that the engagement was appropriately planned. As the audit progresses, the auditor must recognize that changed conditions may make it necessary to modify the planned audit program.

Analytical Procedures

SAS No. 56, *Analytical Procedures* (AU sec. 329), requires the use of analytical procedures in the planning and overall review stages of *all* audits. Analytical procedures used as substantive tests involve comparisons of recorded amounts, or ratios developed from recorded amounts, to *expectations* developed by the auditor.

The precision with which the auditor can develop an *expectation* is the most important factor in determining the level of assurance that a particular analytical procedure provides. In addition, the availability and reliability of the data used to develop the expectation will heavily influence the precision of the expectation. Auditors should ask how much of a difference from the expectation can be accepted without further investigation. When further investigation is necessary, auditors should *scrutinize* the fluctuations. If management has an explanation for the difference, it should be corroborated with other evidence. If management cannot explain the difference, sufficient procedures should be performed to determine that the difference is not the result of a material misstatement of financial statement amounts.

Valuation of Marketable Securities

As a result of the current economic environment, many companies have experienced declines in the market value of investments in marketable equity and debt securities. Auditors should examine evidence to determine whether management properly classified the marketable securities as current or noncurrent assets and whether the amounts at which they are carried in the financial statements are appropriate.

The applicable accounting literature includes FASB Statement No. 12, *Accounting for Certain Marketable Securities* (FASB, *Current Text*, vol. 1, sec. I89); Accounting Research Bulletin No. 43, *Restatement and Revision of Accounting Research Bulletins*, chapter 3A, paragraph .09 (FASB, *Current Text*, vol. 1, sec. I89); and EITF Issue 85-39, *Implications of SEC Staff Accounting Bulletin No. 59—Noncurrent Marketable Equity Securities*.

The applicable auditing literature includes SAS No. 1, *Codification of Auditing Standards and Procedures* (AU sec. 332, "Long-Term Invest-

ments”), and its interpretation, “Evidential Matter for the Carrying Amount of Marketable Securities” (AU sec. 9332.01). The ASB is currently amending the guidance in this interpretation; further information will be included in the December issue of the *CPA Letter*.

For SEC registrants, reference should also be made to guidance provided in the SEC Staff Accounting Bulletin (SAB) Topic 5-M, *Non-current Marketable Equity Securities*, and the Accounting and Auditing Enforcement Release Nos. 309 and 316.

Problems Involving Documentary Evidence

The SEC staff working on accounting and auditing enforcement matters has noted with concern that auditors are being misled by altered copies of documents. This has been an element in some SEC actions, but the risk of accepting a false document in support of a significant transaction is by no means confined to public companies.

SAS No. 53, *The Auditor’s Responsibility to Detect and Report Errors and Irregularities* (AU sec. 316), refers to the authenticity of *original* documents. Auditors should be sensitive to the possibility that a copy of a document is false. Copying machines can be readily used to prepare false transaction support. While the auditor is not an expert in detecting false business documents, *insisting* on inspecting the *original* document will often thwart a fraudulent scheme.

The growing use of fax machines has given rise to questions about the use of fax documents for auditing purposes. Two major concerns about using a fax as audit evidence are ascertaining the *source* of the fax and the vulnerability of the fax to *deterioration*. Auditors can minimize and, in some situations, eliminate these concerns by telephoning the purported sender to confirm that he or she indeed transmitted the document and by making a photocopy of the fax to include with the original fax response in the audit workpapers.

Revenue Recognition

Revenue should not be recorded until it is realized or clearly realizable, the earnings process is virtually complete, and its collection is reasonably assured. Managements of companies might feel pressure to report favorable results—for example, to increase or support the price of the company’s stock, to comply with debt covenants, to obtain or maintain essential financing, or to improve results in anticipation of the possible filing of a registration statement in the near future.

Auditors should be alert for factors indicating that revenue recognition policies may not be appropriate, such as—

- Sales of products that may be subject to a right-of-return arrangement.

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- Certain sales of merchandise that are billed to customers prior to delivery and held by the seller (“bill and hold sales”).
 - “Sales” to intermediaries that add value to the product, with the value-added product subsequently repurchased.

Related Parties

The legal structure of some companies can mask the transactions between related or affiliated parties. Auditors with clients that have complex organizational structures, such as holding companies, should consider whether they have obtained sufficient information about the entities, the control relationships, and the transactions among the parties when evaluating the effect of the transactions on the financial statements. Particular attention should be given to nonmonetary exchanges that provide gains to one or more parties and to year-end transactions that aid one of the parties in reaching its earnings forecasts or meeting its debt covenant requirements.

Some entities may attempt to avoid the recognition of asset impairments by spinning off portions of businesses to shareholders or through some other form of business reorganization. Guidance on such transactions is included in paragraph 23 of Accounting Principles Board Opinion No. 29, *Accounting for Nonmonetary Transactions* (FASB, *Current Text*, vol. 1, sec. N35). Furthermore, for audits of public companies, auditors should consider the guidance in SAB Topics 5-E, *Accounting for Divestiture of a Subsidiary or Other Business Operation*, and 5-U, *Gain Recognition on the Sale of a Business or Operating Assets to a Highly Leveraged Entity*, which describes circumstances in which the sale of a subsidiary or business operation should not be accounted for as a divestiture.

In assessing a related-party transaction, the auditor is required to understand the business purpose of the transaction. An auditing interpretation of SAS No. 45, *Omnibus Statement on Auditing Standards—1983* (AU sec. 9334.16, “The Nature and Extent of Auditing Procedures for Examining Related Party Transactions”), states: “Until the auditor understands the business sense of material transactions, he cannot complete his audit.”

Date of Attorneys’ Letters

The effective date of an attorney’s response to inquiries about litigation, claims, and assessments should be as close to the completion of audit fieldwork as practicable. Consequently, the client’s letter to the attorney should specify that the attorney’s response have an effective date that dovetails with the expected date of completion of audit field-

work. This will obviate the need for an updated response from the attorney. If the attorney's response does not specify an effective date, the auditor can assume that the date of the response is the effective date. In situations when attorneys' letters are dated substantially in advance of the audit report date, the auditor should obtain an updated response, as required by SAS No. 12.

Non-Audit Services

As part of audit planning, the auditor should consider the nature of tax, consulting, or other non-audit services rendered to the client by the CPA firm since the last audit. An auditing interpretation of SAS No. 22 (AU sec. 9311.01, "Communications Between the Auditor and Firm Personnel Responsible for Non-Audit Services") provides guidance on this issue.

Lessons From Litigation

Auditors sometimes find themselves in disputes involving the quality of services provided by their firms. Here are some lessons to be learned:

- Be cautious when dealing with young, extremely rapidly growing organizations, especially those that change the nature of their business. Many major financial statement frauds have involved fast-growing companies.
- Exercise great care in deciding to accept and to retain clients, which are both equally important. For new clients, the reasons surrounding the predecessor accountant or auditor's leaving should be carefully evaluated. Signing an engagement letter without investigating the conditions of the previous auditor's resignation can be costly. The AICPA's *Quality Control Policies and Procedures for CPA Firms: Establishing Quality Control Policies and Procedures* (No. 881556) provides useful guidance in this regard.
- Think like businesspeople while planning and carrying out audits. Gain an understanding of what makes the client's business tick, and perform the work as if you are investigating whether to invest your own money in the company.
- Do not accept unrealistic deadlines; deadlines that are too tight may make it difficult to successfully complete all of the steps in an audit. Such pressure also hinders the ability to step back and appraise the overall results from a critical perspective.
- Do not fail to see the whole picture by becoming too immersed in the details. Deficiencies asserted against auditors do not always

suggest a failure to discover facts. Rather, frequent allegations indicate a failure to recognize the significance of available information and the implications of that information.

- Watch out for large, unusual, one-time transactions, especially those at or near year end, that may be designed to ease short-term profit and cash-flow pressures. Scrutinize these transactions to understand their business purpose, to ensure that the timing of revenue or profit recognition is appropriate, and that disclosures are adequate.

Accounting Issues and Developments

Postretirement Benefits Other Than Pensions

In December 1990, the FASB issued Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions* (FASB, *Current Text*, vol. 1, sec. P40). The Statement significantly changes the prevalent current practice of accounting for postretirement benefits on the "pay as you go" (cash) basis by requiring accrual, during the years that employees render services, of the expected cost of providing those benefits to employees and their beneficiaries and covered dependents. This Statement is effective for calendar-year 1993 financial statements. An additional two-year delay is provided for plans of non-U.S. companies and certain small employers.

In SAB No. 74, *Disclosures Regarding Accounting Standards Issued but not yet Adopted*, the SEC staff expressed its belief that disclosure of impending accounting changes is necessary to inform readers about expected effects on financial information to be reported in the future and should be made in accordance with existing MD&A requirements. Supplemental guidance regarding SAB No. 74 is provided in the November 1990 EITF minutes.

Technical Bulletin on Extended Warranties

In December 1990, the FASB issued Technical Bulletin No. 90-1 titled *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts* (FASB, *Current Text*, vol. 1, sec. R75). The bulletin is effective for contracts sold in fiscal years beginning after December 15, 1990.

According to Technical Bulletin 90-1, revenue from the contracts should be deferred and recognized in income on a straight-line basis, unless it is demonstrated that a significant amount of the costs of performing services under the contract occur at a specific time or on a predetermined schedule. In that case, revenue should be recognized in proportion to those costs.

Costs of acquiring the contract should be charged to expense in proportion to the revenue recognized. In addition, any losses expected on contracts should be recognized by first charging any unamortized contract acquisition costs to expense. If the loss is greater than those costs, a liability should be recognized for the excess.

FASB Issues Exposure Draft on Income Taxes

On June 5, 1991, the FASB issued an exposure draft that would supersede Statement No. 96, *Accounting for Income Taxes* (FASB, *Current Text*, vol. 1, sec. I25). The FASB is revising the Statement to reduce its complexity and to address concerns about the criteria for recognizing and measuring deferred tax assets. The exposure draft would allow certain deferred tax assets for deductible temporary differences and operating-loss and tax-credit carryforwards. If adopted, the proposal would be effective for fiscal years beginning after December 15, 1992. As a result of the proposal, the FASB has proposed a delay in the effective date of FASB Statement No. 96 to fiscal years beginning after December 15, 1992.

Classification of Callable Obligations When a Violation Is Waived by a Creditor

FASB Statement No. 78, *Classification of Obligations That Are Callable by the Creditor* (FASB, *Current Text*, vol. 1, sec. BO5), specifies the balance-sheet classification of long-term obligations that are callable by the creditor. In accordance with the Statement, when a debtor's violation of a provision of a debt agreement at the balance-sheet date makes the obligation callable, the debt may only continue to be classified as a long-term liability if (1) the creditor waives or subsequently loses the right to demand repayment for more than one year from the balance-sheet date or (2) the obligation contains a grace period within which the debtor may cure the violation and it is probable the violation will be cured. In this situation, the auditor should obtain sufficient competent evidence to support the long-term classification. Such evidence should clearly and unequivocally affirm that the lender waives the right to call the debt for a specified period, and may consist of a written communication from the lender to the client or a confirmation from the lender to the auditor.

Subjective Acceleration Clauses and Debt Classification

Long-term debt agreements may contain subjective provisions that, if violated, accelerate the maturity of the debt. In situations where recurring losses or liquidity problems exist, such obligations should be

classified as current liabilities. Reclassification is not required *only* if the likelihood of acceleration of the due date is remote, such as when the lender historically has not accelerated due dates of loans containing similar clauses, and the financial condition of the borrower is strong and its prospects are bright (FASB Technical Bulletin No. 79-3, *Subjective Acceleration Clauses in Long-Term Debt Agreement* [FASB, *Current Text*, vol. 1, sec. B05]).

Industry Developments

The AICPA issues Audit Risk Alerts that focus on recent developments in various industries to provide auditors with overviews of current economic, industry, regulatory, and professional developments that they should be aware of as they plan and conduct their audits. The following industries are covered (product numbers are shown in parentheses):

- Agribusiness (022092)
- Airline (022080)
- Banking (022083)
- Casino (022089)
- Construction Contractors (022088)
- Credit Union (022081)
- Employee Benefit Plans (022078)
- Federal Government Contractors (022082)
- Finance Companies (022090)
- Health Care (022085)
- Investment Companies (022096)
- Life and Health Insurance (022098)
- Not-for-Profit Organizations (022074)
- Oil and Gas Producers (022091)
- Property and Liability Insurance (022094)
- Savings Institutions (022084)
- Securities (022093)
- State and Local Governments (022079)

Copies of these industry updates are available from the AICPA Order Department (800) 334-6961 (outside New York) and (800) 248-0445 (New York only) and are also included in the loose-leaf service for audit and accounting guides.

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